

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

January 8, 2002

IN RE:

CHATTANOOGA GAS COMPANY –
PETITION FOR APPROVAL OF TARIFF
ESTABLISHING PERFORMANCE-BASED
RATE MAKING MECHANISM

DOCKET NO.
01-00619

ORDER APPROVING TARIFF ESTABLISHING A PERFORMANCE-BASED RATE
MAKING MECHANISM

This matter came before the Tennessee Regulatory Authority (the “Authority”) at a regularly scheduled Authority Conference held on September 11, 2001, upon the *Petition for Approval of Tariff Establishing a Performance-Based Rate Making Mechanism* (the “*Petition*”) filed by Chattanooga Gas Company (“Chattanooga” or the “Company”), which was filed on July 13, 2001.

BACKGROUND

Chattanooga’s Petition

In its *Petition*, Chattanooga requests approval of a tariff that would establish a Performance-Based Rate Making (“PBR”) mechanism.¹ According to the *Petition*, the PBR

¹ When asked why it was seeking approval of the proposal as a tariff rather than through a waiver of the PGA Rule, the Company responded:

While the Company could have requested a waiver of TRA Rule provision 1220-4-7-.05, including the terms and conditions under which the rule provision will be waived for Chattanooga Gas Company within its approved tariffs, a tariff appears to be the most practical approach. The terms and conditions that the Company must meet as specified in a public document will be easily accessible to any interested party or to public [sic] in general. Having the provision within the tariff also provides an efficient and convenient method for modifying any term or condition that the Tennessee Regulatory Authority or the Company find necessary to change. Such a change can be accomplished quickly and efficiently through a tariff filing.

Response to Tennessee Regulatory Authority Staff’s Data Request, August 1, 2001, Request No. 4. This appears to be a sound justification for the tariff approach.

mechanism will be a substitute for the prudence review of Chattanooga's purchasing activities provided for in the Authority's Purchased Gas Adjustment Rule (the "PGA Rule"), specifically Authority Rule 1220-4-7-.05. The Company proposes to file an annual report not less than sixty (60) days following the end of each plan year identifying the actual cost of gas purchased and the applicable index for each month of the plan year. Such annual filings would be deemed in compliance with the tariff unless the Authority provides written notification to the Company within 180 days of the filing of the report.²

According to the *Petition*, the PBR mechanism is designed to encourage the Company to maximize its gas purchasing activities at minimum cost consistent with efficient operations and service reliability. The PBR mechanism establishes predefined monthly commodity gas cost benchmark indices to which the Company's commodity cost of gas is compared. The benchmark indices are based on an *Inside FERC* gas market report and a *Gas Daily* price index. Benchmark gas costs will be computed by multiplying total actual purchase quantities for the month by the applicable benchmark index.³

The Company proposes that if its actual total commodity cost of gas does not exceed the benchmark index by two percentage points during any month of the plan year, the Company's gas purchase would be deemed prudent and the audit provided for in Authority Rule 1220-4-7-.05 would be waived. The Company proposes, further, that if during any month of the plan year its actual gas costs exceed the benchmark by two or more percentage points, the Company's gas costs will be audited in accordance with Authority Rule 1220-4-7-.05. Any savings that result from purchases of gas below the benchmark index will be passed on to the Company's customers. The PBR mechanism would continue until it is terminated at the end of a plan year

² *Petition*, p. 2.

³ *Id.*, pp. 2-3.

or by not less than ninety (90) days notice by Chattanooga to the Authority, or it is modified, amended, or terminated by the Authority.⁴

As grounds for its proposal, the Company states that the establishment of the proposed PBR mechanism would facilitate the efficient purchase of gas and eliminate the costs associated with annual audits of gas purchases. The Company states that its gas purchases have been found to be prudent in each of the audits performed since Authority Rule 1220-4-7-.05 became effective in March 1994.⁵

In its *Petition*, the Company proposed that the tariff would be effective August 9, 2001 subject to the Authority's approval.⁶ At the August 7, 2001 Authority Conference, the Directors of the Authority voted unanimously to suspend the tariff for ninety (90) days.

The Consumer Advocate's *Petition to Intervene*

On September 4, 2001, the Consumer Advocate and Protection Division of the Office of Attorney General (the "Consumer Advocate") filed *The Attorney General's Petition to Intervene* in this matter. As grounds for its *Petition to Intervene*, the Consumer Advocate states that although the Company's previous prudence audits have not resulted in any known adjustments, the prudence audit still may have a favorable influence on the Company's gas purchasing practices. The Consumer Advocate states that Chattanooga should continue the past practice of the prudence audit.⁷

⁴ *Id.*, p. 3.

⁵ *Id.*

⁶ *Id.*, p. 4.

⁷ *Attorney General's Petition to Intervene*, p. 4.

FINDINGS AND CONCLUSIONS

Comparison with Existing PBR Mechanisms

Of the three major (Class A) gas companies regulated by the Authority, only Chattanooga does not currently operate under a "PBR" mechanism. Currently, one hundred percent (100%) of Chattanooga's "gas costs," as defined in the PGA Rule, are recovered from ratepayers through the PGA mechanism and trued up annually during the filing of the Actual Cost Adjustment ("ACA"), which is audited by the Authority Staff. After the close of the audit period, an independent consultant conducts an audit of the Company's gas purchasing activities and reports its findings to the Authority.

By Order dated March 11, 1999 in Docket No. 96-00805, the Authority approved a permanent PBR for Nashville Gas Company ("Nashville Gas"), effective July 1, 1998 with an automatic renewal provision.⁸ By Order dated August 16, 1999 in Docket No. 97-01364, United Cities Gas Company's ("United Cities") permanent PBR was approved effective April 1, 1999 with a similar renewal provision.⁹ These two incentive plans were designed to produce monetary rewards for both the ratepayers and the shareholders of the individual companies and to produce improvements in the companies' gas procurement activities. Finding that appropriate incentives were in place, the Authority also approved removal of the Nashville Gas and United Cities from the prudence audit provision of the PGA Rule.

Chattanooga's proposed PBR differs from those approved for Nashville Gas and United Cities in that it does not provide for sharing by the Company in calculated gains or losses. Thus, the proposed PBR does not include any lower limit on gas purchase costs as a percentage of a

⁸ See *Order Approving Performance Incentive Plan*, Docket No. 96-00805 (March 11, 1999). Nashville Gas's PBR continues from year to year unless Nashville Gas terminates the plan at the end of a plan year with ninety (90) days notice to the Authority, or the Authority amends, modifies, or terminates the plan.

⁹ See *Final Order on Phase Two*, Docket No. 97-01364 (August 16, 1999).

market index. Chattanooga states in its *Petition* that “any gas savings that result from purchases of gas below the Benchmark Index will be passed on to Chattanooga Gas customers.”¹⁰ By not incorporating a sharing mechanism into its PBR, the Company, in essence, does not change the way in which the PGA works. One hundred percent (100%) of gas purchases are reimbursed by the ratepayer.

Waiver of the Prudence Audit

The prudence audit performed pursuant to Authority Rule 1220-4-7-.05 requires a substantial commitment of employee time by the Company. These employee costs are eventually passed on to the ratepayers through rates. In addition, approximately \$23,000 per year in consultant fees, which are passed on to the ratepayers through the Actual Cost Adjustment process, can be eliminated. Since the Company’s proposal does not involve an incentive in the sense that the Company is rewarded for purchasing gas below a pre-selected benchmark, it is necessary to define the parameters under which the prudence requirement of the PGA Rule would be waived.

The prudence audit is a safeguard incorporated into the PGA Rule to ensure that gas companies exercise careful management in their purchasing practices. Should an independent consultant, after reviewing a gas company’s purchases, report that in her opinion certain purchases were imprudently made, the Authority may further review the Company’s purchase practices. In order for the prudence audit to be waived, sufficient incentives must exist within the Company’s tariff to safeguard the ratepayer from imprudently incurred gas costs. For Nashville Gas and United Cities Gas, the Authority concluded that the companies had sufficient incentive to strive to make the best purchasing decisions they could, since they would share in any losses as well as any gains incurred when their commodity purchases were compared with a

¹⁰ *Petition*, p. 3.

predetermined benchmark. The benchmarks were established and a "deadband" determined around the benchmarks, within which their commodity purchases would be deemed "prudent" and there would be no sharing. Below this deadband, the companies would share in the gains, and above the deadband, the companies would share in the losses.

Chattanooga proposes to establish a benchmark with an upper deadband limit only. If its commodity purchases do not exceed two percent (2%) above this benchmark in any month during the plan year, then those purchases would be deemed prudent and Chattanooga would be released from the prudence audit requirement of the PGA Rule for that plan year. If, during any month of the plan year, the Company's commodity costs exceed two percent (2%) of the benchmark, then the Company would be subject to an audit of those purchases as required in the PGA Rule.

The framework of Chattanooga's proposed PBR mechanism is similar to that established in United Cities' PBR tariff. Chattanooga has chosen to use two (2) of the four (4) indices used by United Cities. The Company has also proposed the same upper deadband limit as United Cities.¹¹ Since an upper limit of two percent (2%) was approved for United Cities' PBR mechanism, it is reasonable that Chattanooga should be allowed the same range. However, it also appears that in no month during the past two and a half years did Chattanooga's purchased gas cost reach 101% of the benchmark cost. Without a sharing mechanism that would encourage the Company to purchase gas at less than the benchmark, the Company will maintain the status

¹¹ When asked why a two percent (2%) limit was chosen as opposed to one percent (1%) as used in Nashville Gas's PBR, the Company responded that it has designed its tariff to be comparable to United Cities' PBR, except for the sharing, and the two percent (2%) upper limit was approved for United Cities. In both United Cities' tariff and Chattanooga's proposal, the commodity cost of gas is compared to an appropriate market index. Nashville Gas, however, develops its own index each month by taking a market index and factoring in the cost of transportation. Since transportation costs are taken into consideration, Nashville is held to a narrower range of one percent (1%). See Response to Tennessee Regulatory Authority Staff's Data Request, August 1, 2001, Request No. 7.

quo and make no effort to improve its purchasing practices.¹² The two percent (2%) upper limit allows the Company even more latitude than it has demonstrated historically. Therefore, the Authority concludes that a modification of the upper limit is necessary to encourage the Company to continue to purchase gas as economically as possible. On a monthly basis, the Company's purchases will be subject to the upper limit of 102% of the benchmark standard, but in order for the prudence audit to be waived as proposed by the Company, the Company's total purchases for the year must be less than one percent (1%) above the benchmark.

Selection of Market Indices

Chattanooga has selected the market indices *Inside FERC* and *Gas Daily* to serve as benchmarks with which to compare its commodity cost of gas. United Cities' PBR, which the Authority approved in Docket No. 97-01364, uses the following indices: *Inside FERC*, *Natural Gas Intelligence* (NGI), *Gas Daily*, and NYMEX. Consistent with the findings with respect to United Cities' PBR, the Authority finds that the indices proposed by Chattanooga for use in its PBR mechanism are representative of the market place.

Consideration of Chattanooga's *Petition* at the September 11, 2001 Authority Conference

At the September 11, 2001 Authority Conference, counsel for the Consumer Advocate stated that the Consumer Advocate had asked the Company to stipulate that its gas purchasing affiliate, Sequent Energy Management, L.P. ("Sequent"), would purchase gas at the lowest possible cost and would not profit in its sales to the Company.¹³ In response, counsel for

¹² The Authority Staff questioned the Company regarding its incentive to continually improve its purchasing practices under the terms of its proposed PBR. The Company only indicated it had a responsibility for ratepayer satisfaction. See Response to Tennessee Regulatory Authority Staff's Data Request, August 1, 2001, Request Nos. 3 and 5.

¹³ Transcript of Authority Conference, September 11, 2001, p. 26. Counsel for the Consumer Advocate also referred to a document filed with the Authority a few minutes before the beginning of the Authority Conference, in which the Consumer Advocate generally expresses these concerns. See *Attorney General's Comments Regarding the Petition to Intervene*, September 11, 2001.

Chattanooga stated that the Company had agreed that it would make available invoices showing Sequent's gas purchases, as it was currently doing as part of the Company's ACA audit, and that the cost that is incurred by Sequent to purchase the gas would be passed on to consumers by the Company.¹⁴ Counsel for the Consumer Advocate stated that in light of this agreement by the Company, the Consumer Advocate was withdrawing its *Petition to Intervene*.¹⁵

Following these statements, and based upon careful consideration of the *Petition* and of the entire record in this matter, the Authority's Directors voted unanimously to approve the Company's proposed PBR mechanism, with certain modifications as described above. In addition, the Authority unanimously ordered Chattanooga to file a tariff consistent with the Authority's approval of its PBR mechanism, as modified. Further, the Authority ordered the Company to modify its tariff so that the section entitled "Structure of Overview" clearly states the absence of any sharing mechanism in its PBR tariff.

IT IS THEREFORE ORDERED THAT:

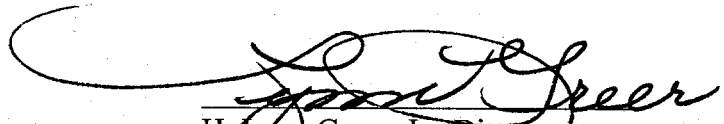
1. Chattanooga Gas Company's *Petition for Approval of Tariff Establishing a Performance-Based Rate Making Mechanism* is approved, with the modification that in order for the prudence audit to be waived as proposed by the Company, the Company's total purchases for the year must be less than one percent (1%) above the benchmark.
2. The Company shall file a tariff consistent with the modification stated above.
3. The Company shall modify its tariff so that the section entitled "Structure of Overview" clearly states the absence of any sharing mechanism in its PBR tariff.
4. Any party aggrieved with the Authority's decision in this matter may file a

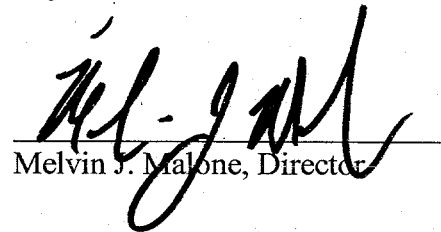
¹⁴ Transcript of Authority Conference, September 11, 2001, p. 26.

¹⁵ *Id.*, p. 27.

Petition for Reconsideration with the Authority within fifteen (15) days from the date of this Order.


Sara Kyle, Chairman


H. Lynn Greer, Jr., Director


Melvin J. Malone, Director

ATTEST:


K. David Waddell, Executive Secretary